VZCZCXRO8744
RR RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV
DE RUEHUP #0593/01 1651325
ZNR UUUUU ZZH
R 131325Z JUN 08
FM AMEMBASSY BUDAPEST
TO RUEHC/SECSTATE WASHDC 3056
RUEATRS/DEPT OF TREASURY WASHDC
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE

UNCLAS SECTION 01 OF 02 BUDAPEST 000593

SENSITIVE
SIPDIS

DEPARTMENT FOR EUR/NCE AND EB/IFD,OMA, AND INR/EC
TREASURY FOR JEFF BAKER AND LARRY NORTON

E.O. 12958: N/A
TAGS: PREL ECON EFIN HU
SUBJECT: IMF ON HUNGARY'S ECONOMY: STABLE NOW BUT WARY
ABOUT GROWTH AND SUSTAINABILITY

Summary

¶1. (U) Growing concerns regarding Hungary's current growth indicators and long-term sustainability have tempered an IMF assessment team's "favorable" assessment of Hungary's short-term, macro-economic indicators. The country has made a good start in its deficit reduction plans but must continue with stalled structural reforms. Its deficit remains the highest in the region, and while it has been able to rein this in since 2006 through revenue enhancements rather then spending cuts, its ability to continue this as elections approach is questionable. Hungary's bond market needs reform as well to increase access for foreign banks to decrease volatility. IMF analysts believe monetary policy decisions have been grounded in sound judgment, noting the recent removal of the exchange rate band and the recent increases in the benchmark interest rate. But caution regarding fiscal practices is still the order of the day, with a continued focus on wages and inflation in the years ahead. End Summary.

A "Start"...But "A Long Way to Go"

¶2. (U) Assessing Hungary's macro-economic situation during its regular Article IV consultations, IMF European Department Assistant Director James Morsink privately briefed Ambassador Foley on June 9. Morsink recently met with senior officials in key government agencies and the Central Bank, as well as with Prime Minister Gyurcsany and FIDESZ opposition leader Viktor Orban. Morsink concludes that while current short-term, macro-economic indicators are trending positively and are "favorable" given the cyclical upturn, he is also concerned about weak growth prospects for the long-term, especially when compared to the regional average.

¶3. (U) Morsink believes indicators including positive GDP growth, declining inflation, a narrowing current account deficit, an improved trade balance due to weak domestic demand, an upturn in private and public investment, and higher labor productivity (output per worker) will be stable in the short-term. He acknowledged, however, that these figures are still weak when compared to other countries in the region and recognized that labor participation is also important. (Note: At 56 percent, Hungary's labor participation rate is among the lowest in the EU countries. End Note.) Morsink said that Hungary has made a "start" in fiscal consolidation, but has "a long way to go" and faces risks ahead.

¶4. (SBU) Morsink believes there is agreement among senior government "technocrats" on what needs to be done - significant structural reforms to cut government expenditures and then lower taxes - but the lack of political will to do so. On macro-economic vulnerability, he said that compared to 2006, when the IMF was very concerned about this, Hungary moved in the right direction last year. But he said there is

concern this year that the fiscal adjustments needed to make further progress have "stalled."

Debt, Debt, and More Debt

¶5. (SBU) Concerning talk of tax cuts, Morsink said the IMF view is that there is no "room for maneuver." He underscored that tax cuts would be possible only if combined with cuts in government expenditures. In a press conference on June 10, Morsink elaborated further that tax cuts must be deficit-neutral and cuts in labor taxes should be balanced with increases in other taxes such as for consumption or property. He also suggested potential expenditure reductions through a combination of reforming welfare programs, health care, education, and the pension system. Commenting that Hungary has the largest debt in the region with high public debt, high net external debt, and high gross external debt; Morsink cautioned that Hungary must continue with macro fiscal consolidation by reducing its fiscal deficit. While the IMF believes Hungary may do even better than its 4 percent of GDP deficit target this year, it is concerned about whether it can achieve its goal of 3.2 percent in 2009 with elections on the horizon.

¶6. (U) Hungary's government bond spreads are wider than others in the region due to its high deficit, according to Morsink. He gave the example of Hungary's recent floating of a Euro bond issue worth 1.5 million Euros at 98 basis points. The day before, the Czech Republic did something similar on the same order of magnitude for 25 basis points. Morsink predicted a major negative impact for Hungary if risk appetite declines.

Liquidity in the Bond Market: Increase Access

¶7. (SBU) Morsink explained that the factors contributing to a freeze in the bond market earlier this year arose from global financial markets being unsettled and the pension fund shift towards equities. He believes these factors were largely beyond the GoH's control, but implied that the pension fund shift could have been better managed as they had been given three years to do this. Morsink believes increasing access for foreign banks to serve as bond dealers is the most important change needed to increase liquidity in the domestic bond market. The Central Bank has told Morsink that it will take action on this proposal in January 2009. He explained that foreign investors interested in the primary market would play a stabilizing role since they would be more willing to take the risk of investing in a small country like Hungary. Morsink also said deepening the repurchase "repo" operations market with the Debt Management Agency and commercial private banks would help liquidity since people would be more willing to take possession of bonds if they know they can get liquidity given a deeper repo market.

Monetary Policy On The Right Track

¶8. (SBU) Commenting that the Monetary Council's decision to remove the exchange rate band was a good thing, Morsink said its subsequent decision to increase the benchmark interest rate to 8.5 percent was also appropriate. He believes there may be a need for further interest rate increases. But Morsink also expressed concerns about the growing number of foreign currency loans being taken by households (estimated at up to 30 percent of outstanding loans) and cautioned that inflation should be down to 3 percent on a 2-year horizon. Emphasizing that nominal wage growth needs to come down, Morsink said reduction in this will bring down core inflation. He explained that with inflation turning out to be higher than expected, the GoH could and may decide to raise wages by 1 percent. The IMF was "surprised" by the small uptick in GDP growth for the first quarter and believes this is what may have contributed to the turnaround this year in private sector wages, which he said was due mainly to the

increase in the minimum wage by sector.

Comment: Economists vs. Investors

¶9. (SBU) Economists and investors continue to look for) and to see) different things as they examine the Hungarian economy. Although the IMF team noted reduced concerns regarding a prospective economic meltdown here, investors continue to focus on growth, transparency, and competitiveness indicators. In tempering its recognition of progress on deficit reduction with a strong public message on the importance of continued fiscal discipline, the IMF team helped ensure that their assessment of macroeconomic stability is not used to further stave off the structural reforms that economists and investors agree are needed.
Foley